Supreme Court, U. S.
FILED
SEP 26 1975
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1974

Docket No. 74-742

FOREMOST-McKESSON INC.,

Petitioner,

v.

PROVIDENT SECURITIES COMPANY,

Respondent.

On Writ of Certiorari to the
United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

As respondent Provident Securities Company's answering brief (hereafter "Provident" and "Res. Br.") would have it, this case should provide the occasion for this Court to re-examine and reverse, or rewrite the statutory language, not only in respect of the *Stella* doctrine, as to which certiorari was granted, but also as to many other presumably settled principles of Section 16(b) law, including but not limited to the definitions of "purchase", "sale", "beneficial ownership" and "equity security", the decision of the Second Circuit in *Chemical Fund, Inc.* v. *Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967), and the meaning of

SEC Rule 16a-2. Insofar as the amicus brief of Gulf & Western Industries (hereafter "G&W" and "G&W Br.") is concerned, this reply brief constitutes our first opportunity to deal with the several arguments that were not proffered by Provident but are advanced by G&W.

ARGUMENT

I

The initial purchase of 10% of an issuer's securities is a Section 16(b) "purchase".

A. The Legislative History "Affords No Explanation of the Purpose of the Proviso".

Provident and G&W, like the alchemists of old, seek to transmute the dross of the alleged legislative history of Section 16(b)'s proviso into a treasure-trove of support for a construction of the statute which would render it largely ineffectual in dealing with abuses arising from transactions involving beneficial owners of 10% of the equity securities of issuers. Both have come late to the apparent conclusion that this Court was in error when it determined that the legislative history affords no explanation of the purpose of the proviso. *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418, 424 (1972).*

At most, what Provident and G&W have extracted from the legislative history is that early drafts of Section 16(b)

* It should be noted that G&W had not argued the point here involved in the Seventh Circuit in its regularly filed briefs, save to note the point in a footnote. Only when the Ninth Circuit decision in the instant case was filed did it seek leave to file supplemental briefs in the Circuit Court on this point. This history bears striking resemblance to Provident's decision not to urge this point before the Ninth Circuit.

(S. 2693 and H.R. 7852) may be read as requiring prior beneficial ownership of 5% before subsequent purchases and sales are subject to the statute. But there is no doubt that the language of the early bills, including the specific language on which Provident and G&W rely, was altered or deleted prior to enactment. The fact that Provident and G&W offer possible explanations for those changes is hardly affirmative support for their contention that the "clear" limitation of the prior bills survives the elimination of the language which made the limitation "clear".* What emerges from the entire discussion in both briefs is support for this Court's conclusion that the legislative history "affords no explanation of the purpose of the proviso." We have consistently maintained this position in our briefs to this Court with respect to the proviso, while arguing on the other hand that the general legislative purposes of Section 16(b) as a whole are only fulfilled by the construction which we offer. (Foremost Br. 18-20, 25-32; Cert. Pet. 14-15) However, if we, like our opponents, were to indulge in speculation as to why the language of the proviso was substituted, it would not seem unlikely that when Congress changed the 5% ownership requirement in the original bills to 10%, it decided to counterbalance the relaxation of

* While amendment of critical language would generally make any early bill, and comments thereon, highly dubious guides to interpreting an amended bill, this is particularly true here where their principal draftsman admitted that the insider trading provisions of S.2693 and H.R. 7852 were not well drafted. *Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. 6557-58 (1934) (Thomas Corcoran stated that the sale-repurchase situation "should have been provided for * * *"); *Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 133 (1934) (Mr. Corcoran observed that H.R. 7852 was not limited to directors and officers who also own 5% of the stock and was "badly drawn" in suggesting such a limitation).

that provision by ensuring that the transaction by which one attains 10% beneficial ownership would constitute a statutory "purchase".

G&W pays particular attention to the language in the initial draft bills declaring unlawful purchases by insiders "with the intention or expectation of selling" within six months, and argues that:

> "[t]he statute aims expressly at the person who buys stock [intending] *based on inside information* to sell at a short-term profit and necessarily contemplates *the statutory relationship, and informational access,* before his purchase." (G&W Br. 11) (emphasis supplied).

Not the least of the defects of this argument is that the early bills specifically provided that intention to both buy and sell within a six-month period would *not* be a substantive element of the statutory liability. Moreover, even if Congress had chosen to make such intention a required element of liability, it does not follow that at any point in the drafting process Congress also assumed, as G&W suggests, that statutory ownership (5% at the preliminary stage discussed) would invariably have to be reached before the purchase. A person owning some shares, but less than the 5% statutory benchmark, could acquire inside information and thereafter make a second purchase increasing his ownership to the statutory level fully intending, at the time of the second purchase, to exploit the information by selling within the next six months. The unlawful intention required under the draft legislation could well exist prior to or simultaneously with a purchase conferring the percentage of ownership required to invoke the draft statute's sanctions.

G&W's argument also ignores the fact that manipulation by insiders was a subject of considerable Congressional concern at the time of Section 16(b)'s adoption. S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934); Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6559 (1934) (hereinafter "Senate Hearings"). A person contemplating influencing corporate affairs to his own advantage after acquiring a large block of equity securities might intend to sell within six months in order to profit from his manipulative activities. The pre-purchase intention to sell in such a case could well be based solely on the contemplated manipulation and not at all "on inside information". In short, G&W's reliance on the language relating to an intention, allegedly based on the prior possession of inside information, to buy and sell within six months, language which was never enacted and indeed was never even determinative of liability in the draft bills, evidences an extremely circumscribed view of Section 16(b), and one that cannot be said to reflect the intent of the Congress which enacted the statute.

We note that the *Stella* case*—which both Provident and G&W argue was decided contrary to Congress' intent—is more than twenty years old, yet no action has been taken by Congress to reverse its construction of Section 16(b). In *Blau* v. *Lehman,* 368 U.S. 403 (1962) the Court refused to apply Section 16(b) to partnership short-swing profits where one of the partners sat on the issuer's board of directors. It relied in part on the fact that a lower court

* Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), *cert. denied,* 352 U.S. 831 (1956), approving Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952).

decision reaching the same result had been called to Congress' attention in the SEC's annual reports, despite which Congress had failed to amend the statute. 368 U.S. at 412-13 and n. 13. Here too, Congress has not acted to amend the statute to reverse the decision in *Stella* and the cases following it, despite its knowledge of that decision through SEC reports.* See 18 SEC Ann. Rep. 78 (1953).

B. The Statutory Policy Requires Application of Section 16(b) to a Purchase Conferring 10% Beneficial Ownership.

While the legislative history does not in explicit terms give guidance to the meaning of the language here at issue, nevertheless a construction of Section 16(b) exempting a purchase conferring 10% beneficial ownership will contravene the statute's purpose of preventing insider trading abuses. It is the potential for abuse, not actual abuse, at which Section 16(b) is aimed.

> "[T]he only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great." *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418, 422 (1972).

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* Congress' failure to amend Section 16(b) to reverse its long-standing judicial and administrative construction derives added significance from the fact that the Securities Exchange Act was extensively revised in other respects both in 1975 (Securities Acts Amendments of 1975, P.L. 94-29, 89 Stat. 97 *et seq.*) and in 1964 (Securities Acts Amendments of 1964, 78 Stat. 565 *et seq.*). *See* Zemel v. Rusk, 381 U.S. 1, 11-12 (1965); Electric Storage Battery Co. v. Shimadzu, 307 U.S. 5, 14 (1939).

It was the 1964 amendments, as Provident and G&W correctly point out, which added present Section 16(d) to the Exchange Act. We regret reference to that subsection in our principal brief's discussion of "contemporaneous" evidence of the intended meaning of Section 16(b).

As was recently observed in a different context in *Lewis* v. *Arcara,* [Current] CCH Fed. Sec. L. Rep. ¶95,238 (S.D. N.Y. July 18, 1975):

> "The history of section 16(b) shows that Congress intended Draconian enforcement to avoid any loopholes. Congress wrote section 16(b) so that in cases such as this the liability of the insider would not be subject to disputation and thus the law would have its intended prophylactic effect." ¶95,238 at 98,252-53 (footnote omitted).

Notwithstanding these unquestioned principles, the construction of the proviso contended for by G&W and Provident would render the statute inapplicable to all but the most unsophisticated transactions by 10% holders, contrary to the manifest statutory purpose. Among the cases which would escape the statutory sanction are the following. In each example almost any percentage between 10% and 100% could be substituted for the "10%" used in the illustrations.

(1) A purchaser acquires 10% of the issuer's securities from the issuer or one or more large stockholders on the basis of inside information obtained during negotiations leading to the purchase, or at some prior time, and sells the securities purchased at a profit within six months of the purchase.

(2) A purchaser of 10% of the issuer's securities acquires inside information within six months of the purchase prompting an immediate sale of his holdings at a profit.

(3) A purchaser of 10% of the issuer's securities utilizes his position to influence corporate affairs, selling the securities purchased within six months at an artificially inflated price.

(1) G&W vigorously attacks application of the statute to the first situation insofar as it relies on the possibility of obtaining inside information during negotiations looking toward a 10% purchase on the ground that "this theory is woefully inadequate in describing the likely means of achieving a stock interest * * *." (G&W Br. 22 and n. 32) To be sure, some large purchasers (perhaps including G&W) undoubtedly do acquire their interests by processes, such as open-market purchase, that may involve no contact with the issuer or other insiders. But the negotiated purchase is certainly the more likely form for acquisitions of this magnitude (as well as the form of the transaction at issue here) and the fact that *some* large purchases do not involve negotiations between issuer and purchaser is an insufficient basis on which to refuse to apply a prophylactic rule to any of them. The principle enunciated by Judge Weinfeld in *Lewis* v. *Arcara*, [Current] CCH Fed. Sec. L.Rep. ¶95,238 (S.D.N.Y. July 18, 1975) is applicable here:

> "Such an accommodation in the unexceptional circumstances of this case not only runs counter to the intended automatic application of the statute to recapture 'any profit realized', but also affords the opportunity to evade its purpose." ¶95,238 at 98,253.

In *Champion Home Builders Co.* v. *Jeffress*, 490 F.2d 611 (6th Cir.), *cert. denied*, 416 U.S. 986 (1974), the insider apparently obtained actual inside information in the course of negotiations leading to his acquisition of 13% of the issuer's stock. 490 F.2d at 618.

The argument (Res. Br. 13-14, 29-30; G&W Br. 22-23) that the Court's decision in *Kern County Land Co.* v. *Occidental Petroleum Corp.*, 411 U.S. 582 (1973) (hereinafter

"*Kern County*") precludes application of Section 16(b) to prevent exploitation of pre-purchase inside information has already been considered. (Foremost Br. 33-35) Suffice it to say that *Kern County* hardly stands for a *blanket* exclusion from the statute of cases in which information is acquired prior to the time that "substantial stockholdings" are acquired, and further that, contrary to G&W's assertion (G&W Br. 23), there is no requirement in the statutory language that a right to purchase be "intertwined with unfair access to information" in order for the acquisition of such right to be deemed a purchase under the statute. See *Chemical Fund, Inc.* v. *Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967) (purchase of debentures convertible into 10% of underlying common would confer insider status).

Finally, G&W's claim (G&W Br. 22) that interpreting the statute so as to deter 10% purchases based on information acquired prior to purchase would resurrect the deleted "tippee" liability provision is without merit. Any person to whom inside information is communicated by another, whether before or after acquiring insider status, could be called a "tippee". Section 16 has no application to "tippees" as such, but only to officers, directors and 10% holders whether or not they are actual "tippees".

(2) Relying also on *Kern County*, Provident urges that "there can be no presumption of access to inside information until after such time as one has become an owner of more than 10% of an issuer's securities". (Res. Br. 14, 29-30). But this argument speaks not at all to the second situation set forth above. Even if Section 16(b) presumes an inability to *obtain* inside information until 10% ownership is acquired, the fact remains that a 10% holder is able

to *exploit* information obtained as a result of his position by a single sale transaction. It is the position of the insider at the second or "closing" transaction which is crucial in determining whether there was a possibility of speculative abuse. See Brief for SEC as Amicus Curiae at 18-19, 22, 24 and Supplemental Brief for SEC as Amicus Curiae at 5-8, *Gold* v. *Sloan,* 486 F.2d 340 (4th Cir. 1973), *cert. denied,* 419 U.S. 873 (1974).

It was precisely this consideration which led the court in *Newmark* v. *RKO General, Inc.,* 425 F.2d 348 (2d Cir.), *cert. denied,* 400 U.S. 854 (1970) to apply the statute to a purchase conferring 10% beneficial ownership.

> "The statutory reference to a ten percent beneficial owner rests on the presumption that an owner of this quantity of securities has access to inside information (footnote omitted). Although this presumption would not justify the conclusion that one who purchases a quantity of shares which makes him a ten percent beneficial owner has done so on the basis of inside information, the presumed access to such information resulting from this purchase provides him with an opportunity, not available to the investing public, to sell his shares at the moment most advantageous to him. Thus, a purchase of shares which makes the buyer an insider creates an opportunity for the type of speculative abuse the statute was enacted to prevent." 425 F.2d at 356.

"That RKO's heart may have been pure and its motivation noble matters not. The significant factor is whether RKO *could have* reaped a speculative profit from the 'unfair use of information • • • obtained • • • by reason of [its] relationship to [Central].'" 425 F.2d at 353.

And it was precisely this possibility which was absent under the peculiar facts of *Kern County* not only because the opposition between the offeror and target company management rendered "extremely remote" the possibility that the offeror could have obtained confidential information but also because both the occurrence and timing of the defensive merger "sale" were "out of [the offeror's] hands." 411 U.S. at 598, 599.

We note G&W's quotation (G&W Br. 27) of the Eighth Circuit's hypothetical in *Emerson Electric Co.* v. *Reliance Electric Co.,* 434 F.2d 918 (8th Cir. 1970), *aff'd on other grounds,* 404 U.S. 418 (1972) regarding a purchase of 51% of the issuer's securities:

> "Illustrative of some of the mischief that would be permitted in spite of Congress' action in enacting 16(b) if we accorded with Emerson's contentions is an initial purchase of as large a block of stock as 51 percent or more of a corporation's stock, followed by a sale any time within six months by the stockholder who obviously within that period could obtain much inside information and also could influence, manipulate, or control corporate transactions. The deterrence of such apparent potential mischief must have been within the contemplation of Congress." 434 F.2d at 924.

We simply cannot agree with G&W's blithe assumption that such a case is not covered by Section 16(b).

G&W rejects "the spurious post-purchase information theory" based in part on its analysis of the legislative history discussed above and in part on certain additional grounds purporting to show that "when such a theory of liability is tested, the structure of the statute breaks down."

(G&W Br. 20-22) The reverse is true.* Moreover, this "spurious" theory received a much less hostile reception from the Court in *Kern County* than it receives from G&W. After determining that the period prior to the tender offeror's acquisition of 10% ownership did not present the potential for speculative abuse at which Section 16(b) is aimed, 411 U.S. at 596-97, the Court went on to consider whether abuse of inside information could have occurred in the period *after* 10% ownership had been obtained, concluding that the possibility of informational access during the latter period "seems extremely remote" in the context of a hostile tender offer. 411 U.S. at 598. This portion of the Court's opinion certainly suggests acceptance rather than rejection of the "post-purchase information theory" in the more typical context involved here of cooperation between purchaser and seller.

G&W's claim that the "structure of the statute breaks down" in the post-purchase information case (G&W Br. 20-21) is founded on a misconception of the purpose of Section 16(b). The statute was not designed to apprehend

* The courts have repeatedly held that Section 16(b)'s purposes are best effectuated by imposing liability despite the fact that a statutory prerequisite is satisfied only at the time of the second or closing transaction.

> "* * * [S]ince §16(b) does not expressly require that the stock held by an officer or director of a corporation must be registered on a national securities exchange at the time it was purchased as well as when it was sold, we will not infer such a requirement contrary to the manifest statutory purpose." Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569, 572 (E.D. Pa. 1962).

The court held in *Perfect Photo* that listing at the time of sale is sufficient for Section 16(b) purposes. The same principle underlies cases such as Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) applying Section 16(b) where only the second transaction occurs after officer or director status has been attained. See Foremost Br. 23-24 and p. 17 *infra*.

and render liable in damages actual traders on inside information: rather its purpose was to *deter* insider trading in the first instance by means of "a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great," *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418, 422 (1972), without regard to "actual abuse of insider information," *Kern County* at 595. Accordingly, G&W's attempt to discredit the post-purchase information theory by showing that Section 16(b) recoveries from persons actually possessing inside information acquired subsequent to purchase will not conform to such persons' monetary "advantage * * * over the public stockholders" is wholly misdirected. (G&W Br. 20-21 and nn. 28, 29) The statutory recovery from an *innocent* insider whose transactions violate Section 16(b) would appear to be an even more "capricious, irrational penalty" (G&W Br. 22) if it were intended to be measured against standards applicable to damage recoveries for actual wrongdoing, as in the cases inappropriately cited by G&W. But Section 16(b) does not purport to measure the actual value of inside information. It seeks instead to deter possible misuse of inside information, without assessing the actuality of wrongdoing, by the automatic forfeiture of an insider's profit measured only by the net gain on prohibited matching transactions.

(3) The policy of preventing insiders from influencing corporate affairs to generate short-swing profits for themselves constitutes a third alternative ground for applying Section 16(b) to a purchase conferring statutory ownership. The fact that Section 16(b) was directed, at least in part, against such practices, S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934) (examples cited of controlling insiders

formulating dividend policies productive of personal trading profits); S. Rep. No. 1455, 73d Cong., 2d Sess. 67 (1934); Senate Hearings 6559 (statute aimed, *inter alia,* "at the general evil of officers and directors rigging their stock up and down * * *"), has been recognized not only by this Court, *Kern County* at 592 n. 23,* but also by lower courts interpreting the statute, *Emerson Electric Co.* v. *Reliance Electric Co.,* 434 F.2d 918, 924 (8th Cir. 1970), *aff'd,* 404 U.S. 418 (1972); *Blau* v. *Lamb,* 363 F.2d 507, 515, 521 n. 19 (2d Cir. 1966), *cert. denied,* 385 U.S. 1002 (1967); *Adler* v. *Klawans,* 267 F.2d 840, 845, 848 (2d Cir. 1959), and by Provident itself. (Res. Br. 12 quoting Foremost Br. 18) While other remedies may exist for manipulation, Section 16(b) was designed as an automatic deterrent to such activities without the added requirements of proving a case under Sections 9 or 10 of the Exchange Act.

Although G&W minimizes the manipulative power of 10% shareholders, it is clear that Congress did not share its view.** Indeed, the very purpose of including substantial

* "The legislative history of §16(b) reveals a congressional effort to curb short-swing trading by insiders whose position gives them access to information not available to the investing public *and the ability to influence corporate policy.*" (emphasis supplied)

** "Mr. Corcoran. Five percent is a lot in a modern corporation. Many corporations are controlled by 5 percent or 10 percent.

* * *

Mr. Corcoran. A stockholder owning 5 percent is as much an insider as an officer or director. Whether he is a titular director or not, he normally is, as a practical matter of fact, a director." *Senate Hearings* 6556.

"Mr. Pecora. We had evidence here last summer from Mr. Van Sweringen. He and his associates felt that if they could acquire a block of stock which amounted to around 10 or 15 percent of an important railroad line, they would thereby get a management control. He admitted that very blandly.

* * *

(footnote continued on next page)

beneficial owners in the statute was to reach individuals whom Congress regarded as functional equivalents of corporate officers and directors for most purposes.

G&W purports to find sanction for its position on this point (G&W Br. 15-17, 23, 28) in certain language of the present Chief Justice in *Adler* v. *Klawans,* 267 F.2d 840 (2d Cir. 1959). However, the question before the court in *Adler* was whether Section 16(b) reaches a purchase and sale by a director who has not assumed office at the time of the purchase. The court noted that the proviso exempts a beneficial owner whose purchase *precedes* the attainment of 10% ownership (a proposition that is not disputed here) and relied on this observation to hold Section 16(b) applicable to the case before it on the ground that directors would have been included in the proviso had Congress intended exemption of pre-directorship purchases. 267 F. 2d at 845. But the court was obviously not called upon to decide whether the proviso exempts a purchase *conferring* 10% beneficial ownership. Moreover, its opinion, insofar as it intimates a view on that question, approves the broadly remedial approach to the statute embodied in *Stella's* application of Section 16(b) to a purchase conferring 10% beneficial ownership. 267 F.2d at 846.

Because a construction of Section 16(b) making it inapplicable to a sale within six months of a purchase con-

Mr. Pecora. The only point I want to make is that with that evidence in mind, that management control of an active stock could be obtained through control of 10 percent of the outstanding stock—and there was a large amount of stock outstanding—where an individual owned as much as 5 percent or more, he would be in a position, through that ownership of a block of stock of that size, to virtually be an insider, and he could very well dictate, with one or two others, elections to the board of directors." *Senate Hearings* 7742.

ferring statutory ownership would remove each of the three paradigm cases outlined above from its prophylactic operation, and because it was undoubtedly the purpose of Section 16(b) to deter the abuses exemplified by those cases, such a construction should be rejected as inconsistent with the statutory policy.

C. Provident Has Failed to Distinguish the Pertinent Authorities.

Provident argues that the District Court in *Stella* v. *Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952) did not "directly address" the question whether a purchase conferring 10% ownership is comprehended by Section 16(b) (Res. Br. 17); in other words, did not "directly address" the only question before the court and the one that it decided. G&W suggests that the *Stella* result would have been different had the case involved "an investor with no previous relationship to the issuer," (G&W Br. 29) rather than one who had been a 10% beneficial owner prior to the purchase in question, which re-established his 10% holding. But the District Court never relied on the defendant's prior inside relationship to the issuer in support of its holding—and it is hard to see how it could have, since such relationship had ceased more than a year prior to the purchase in question (104 F. Supp. at 958)—and subsequent Second Circuit cases sustaining the court's interpretation of the statute contain no such requirement. *Perine* v. *William Norton & Co., Inc.*, 509 F.2d 114 (2d Cir. 1974); *Newmark* v. *RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970). In *Perine*, there was no "prior insider relationship between [the defendant] and the issuer", 509 F.2d at 117, while in *Newmark*, contrary to G&W's suggestion (G&W Br. 26-27), the existence of such a relationship was not essential to the court's decision.*

Cases holding that purchases by officers and directors prior to assuming office fall within Section 16(b) (Foremost Br. 23-24) are deemed irrelevant by Provident because, it is contended, the statute distinguishes beneficial owners from other insiders, as evidenced by the proviso at issue here. (Res. Br. 19-20) However, the decisions involving officers and directors necessarily recognize that abuses within the purview of Section 16(b) can occur where a purchase precedes attainment of insider status and it is difficult to see how this view of the statute, notwithstanding the proviso, is any less applicable to a beneficial owner whose purchase does not merely precede but confers insider status.

These cases also speak to G&W's legislative history argument that H.R. 7852 and S. 2693 "necessarily [contemplate] the statutory relationship, and informational access, before his purchase". (G&W Br. 11) Were they all wrongly decided? If not, a much larger question looms—why would Congress, without any apparent discussion of the point, require what G&W claims is the intended sequence of purchase of 10% before obtaining access to inside information in the case of beneficial owners, but depart from this

* The court held that defendant's "single purchase" of over 10% of the issuer's stock triggered Section 16(b) and cited a prior inside relationship, based on the purchase contract itself, only as alternative support for the result reached. 425 F.2d at 355-56. Interestingly enough, the *Newmark* alternative rationale would lead to the conclusion that Provident became a "beneficial owner" of Foremost's debentures on September 25 when it entered into the Purchase Agreement. Under *Newmark* there would be no doubt that Provident was already a 10% owner when, according to Provident's contention, it "purchased" the debentures on September 26.

allegedly intended sequence in the case of directors and officers?

Both Provident and G&W also dispute Foremost's claim that Rule 16b-2, 17 C.F.R. §240.16b-2, promulgated in 1935, evidences the SEC's belief that Section 16(b) reaches a purchase conferring 10% beneficial ownership. G&W characterizes Foremost's Rule 16b-2 argument as "backwards bootstrapping" (G&W Br. 17), ignoring the many cases in this Court holding that the construction given a statute by the agency charged with its enforcement is entitled to judicial deference. See *e.g., NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 275 (1974); *Johnson* v. *Robison*, 415 U.S. 361, 367-68 (1974). Moreover, the initial version of the Rule did not, as contended by G&W, depend on "the model of a pre-existing [inside] relationship * * *". (G&W Br. 18) Rule NB2, as adopted in 1935, provided an exemption from Section 16(b) for purchase and sale transactions upon three basic conditions, only two of which are relevant here: (i) that the purchase is made, with a view to distribution, from the issuer or another participant in the distribution; and (ii) that the person making the transaction is in the business of buying and selling securities for his own account. Thus, Rule NB2 exempted the normal firm commitment underwriting by an underwriter whose only connection with the issuer is its purchase of the securities to be distributed, and this type of transaction remains the principal focus of the current version of the Rule. Accord, *Perine* v. *William Norton & Co., Inc.*, 509 F.2d 114 (2d Cir. 1974).

Provident argues (Res. Br. 27) that Rule 16b-2 could have application to purchases and sales by underwriters during market stabilization efforts undertaken after acquisition of the securities to be sold even if Section 16(b) does *not* reach the initial purchase. But this argument, if offered to cast light on either the original or the principal purpose of the Rule, necessarily founders on SEC Securities Exchange Act Release No. 6131 (December 4, 1959) amending Rule 16b-2, twenty-four years after its adoption, to "make it clear that when the conditions of the [rule] are met, certain *other* transactions * * * are also exempted * * * [including] (1) stabilizing transactions * * *" (emphasis supplied).

II

The transaction at bar does not fall within the principle exempting unorthodox transactions involving no potential for speculative abuse from the operation of Section 16(b).

Provident's attempt to force its purchase of convertible debentures into the mold of an "unorthodox" transaction involving no potential for speculative abuse (Res. Br. 32-48), if successful, would seriously impair Section 16(b)'s intended "automatic" operation by treating garden variety transactions as exceptions to the statutory scheme.

A. The Transaction at Bar Was Not "Unorthodox"

Seeking to characterize its purchase of Foremost convertible debentures as an "unorthodox" transaction, Provident offers a potpourri of factors said to distinguish the purchase from a "traditional cash-for-stock transaction" (Res. Br. 33), principal among which is the nature of the security purchased by Provident. Provident not only bases

its claim that the transaction was unorthodox in part upon the fact that it purchased convertible debentures rather than stock (Res. Br. 33-34), but also rests its assertion that Section 16(b) would be unconstitutional as applied to the transaction at bar on this point. (Res. Br. 45-48) Both arguments rely heavily on selective quotation from the Second Circuit's decision in *Chemical Fund, Inc.* v. *Xerox Corp.*, 377 F. 2d 107 (2d Cir. 1967). To be sure, the Second Circuit did observe in that case that a holder of convertible debentures does not *necessarily* have insider status equivalent to that of officers, directors or 10% stockholders. It held that only such holders who, upon a hypothetical conversion of their debentures, would own more than 10% of the then outstanding common stock are subject to the statute. This concept is embodied in the statutory definition of "equity security" contained in §3(a)(11) of the Exchange Act, 15 U.S.C. §78c(a)(11), and in the provisions of Rule 16a-2, 17 C.F.R. §240.16a-2, promulgated by the SEC. Since Provident does not and cannot dispute the fact that its holdings satisfied the hypothetical conversion test of *Chemical Fund* (Foremost Br. 38-39), its arguments in fact receive no comfort from that case. Provident's position as a holder of debentures convertible into more than 10% of the underlying common stock was functionally equivalent to that of an owner of 10% of the common for Section 16(b) purposes, and the fact that it purchased debentures rather than stock fails to establish either the "unorthodoxy" of the purchase transaction or the unconstitutionality of Section 16(b) as applied to it.

Additional circumstances relied on by Provident to establish "unorthodoxy" are also without merit. Provident's claim that it did not wish to acquire Foremost's

debentures (Res. Br. 33, 35-36) has already been discussed. (Foremost Br. 50-51) It is difficult to see how Provident's initial desires in this regard bear on the "orthodoxy" of a transaction in which debentures were actually acquired. In any event, Provident clearly "desired" the debentures sufficiently to choose to take them rather than to forego the transaction. Moreover, there can be no dispute that it was Provident that initiated the entire transaction and employed Dillon, Read "to look for a purchaser for Provident's assets." (A74) Indeed, by virtue of exchanging its assets for debentures rather than for cash, Provident was able to realize a profit which it would not have obtained in a cash transaction. This suit seeks only to recover that profit.

Provident also tries to make much of the form of consideration for its purchase of Foremost debentures. (Res. Br. 33, 35-37) But surely the Ninth Circuit was correct in concluding that no meaningful distinction can be drawn "between consideration in the form of cash and consideration in the form of a corporate asset." 506 F.2d at 605. The statutory definition of "purchase" includes "any contract to buy, purchase, or *otherwise acquire*," §3(a)(13), 15 U.S.C. §78c(a)(13) (emphasis supplied), language which supports the Ninth Circuit's refusal to accord significance to the non-cash nature of the consideration. The "inherent possibility of speculation" (Res. Br. 35) is not altered one iota by the nature of the consideration which an insider parts with in paying for his equity securities.

B. The Transaction Was Capable of Speculative Abuse

Provident offers as a springboard for its argument that, as a matter of fact, it did not have inside information (Res. Br. 37-38) this Court's statement that "[i]n interpreting the terms 'purchase' and 'sale', courts have properly asked whether the particular *type of transaction involved* is one that gives rise to speculative abuse." *Kern County* at 595, quoting *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418, 424 n.4 (1972) (emphasis supplied). No case holds, however, that Section 16(b) liability depends upon a case-by-case analysis of whether actual abuse has occurred.

Considering the type of transaction involved here, it certainly cannot be contended that in an assets-for-equity security transaction, as a general rule, the corporation receiving the equity security has no interest in information concerning the issuer. On the contrary, such a corporation would normally be as vitally interested in information bearing on the value of the security it was to receive as would any other purchaser, and, in addition, it would have inside information superior even to that of the issuer in respect of the assets the issuer was acquiring from it. Such transactions involving cooperative negotiations prior to the acquisition obviously present a potential for speculative abuse* at least equal to and sometimes greater than that involved in a cash for stock transaction.

* Provident's principal factual arguments—*i.e.*, that the negotiations preceding its purchase of Foremost debentures "involved only an evaluation of *Provident's assets* which were to be transferred to Foremost" (Res. Br. 38) and that Provident "did not in fact have any access to Foremost's books and records or any other inside information about Foremost" (Res. Br. 38), are without citation to, or support from, the record.

Little more need be said about Provident's claims of unconstitutionality. (Res. Br. 45-48) Prior claims that Section 16(b) is unconstitutional have been uniformly rejected. *Gratz* v. *Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Park & Tilford, Inc.* v. *Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Smolowe* v. *Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). And the distinction relied on by Provident to differentiate those cases, the fact that it purchased debentures rather than stock, is simply too evanescent to withstand scrutiny, particularly where, as here, the hypothetical conversion test of *Chemical Fund* is satisfied. Nor is there anything surprising in the application of Section 16(b) to these facts: the *Stella* case was decided twenty years ago and Provident itself anticipated a "Section 16(b) problem" from its purchase and sale of the debentures. (A126) Finally, it must be remembered that Section 16(b) does no more than take the profit out of certain types of transactions which involve an unacceptable risk of speculative abuse: it neither prohibits the transaction nor imposes a penalty beyond such profit.

III

The sale took place on October 21, 1969.

Provident further attempts to relitigate settled law under Section 16(b) by claiming that the Underwriting Agreement of October 21 (A135) did not effect a "sale" within the meaning of Section 16(b). In arguing that there is "no reason to depart from the *ordinary* definition of the word 'sale'" (Res. Br. 52) (emphasis supplied), Provident

would override the *statuory* definition of a sale which includes a "contract to sell". See *Blue Chip Stamps* v. *Manor Drug Stores,* 95 S. Ct. 1917, 1932 (June 9, 1975). While Provident makes reference to the statutory definition, it contends that this language must be construed "in the context of a particular transaction." (Res. Br. 49) Again this is a suggestion that every issue regarding Section 16(b) liability must be decided on a case by case basis. On the contrary, it is essential to fulfill the purposes of Section 16(b) that a contract of sale be considered a "sale". Otherwise, an insider could easily avoid the proscriptions of the statute by entering into a contract to sell stock within the six-month period, thereby fixing his profit, with the closing under the contract to take place after the six-month period.

While Provident apparently does not dispute that the Underwriting Agreement was a contract, it seems to contend that the standard provision (A135, ¶5(h)) giving the underwriters an "out" in the event of a material and unfavorable change in the condition of Foremost in the week between October 21 and October 28, which change did not in fact occur, transforms that agreement into the type of option agreement considered in *Kern County.* There, however, the optionee (Tenneco) was under no obligation to buy at all. In contrast, the conditions in the Underwriting Agreement are included in virtually all such agreements and, given the short span between execution and closing which typifies them, are almost sure to be satisfied with the mere passage of time. The existence of such conditions does not detract from the fact that Provident exercised its

speculative judgment and admittedly bound itself to sell the debentures at a profit on October 21, 1969.*

Finally, with reference to fixing the sale date, Provident refers to *Champion Home Builders Co.* v. *Jeffress,* 490 F. 2d 611 (6th Cir.), *cert. denied,* 416 U.S. 986 (1974). There the court found that the statutory purchase occurred on the date the contract between the insider and his corporation was executed rather than on a prior date on which the Board of Directors had adopted a resolution which the court characterized as "nothing more than an authorization to negotiate" and "no more than a license to bargain." 490 F. 2d at 617. More significantly for the present case, however, is the court's refusal to adopt as the date of purchase the later date (April 24) when the agreement was approved by the Board of Directors, although the agreement as executed on April 17 was subject to such approval. In reaching the conclusion that the date of the contract was the crucial date, the court referred to the Form 3 Report which stated April 17 as the date of acquisition of beneficial ownership and held that it was on that date that the insider incurred an irrevocable liability to take and pay for the stock. The fact that the corporation was not obligated to sell until approval by the Board of Directors a week later did not affect this conclusion. 490 F. 2d at 618.

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* While Provident seems to deny it (Res. Br. 50), the Form 4 Statement filed by it on October 31, 1969, refers to the sale of $25,000,000 worth of debentures and under the column "Date of Transaction" specifies "October 21, 1969", the date that the Underwriting Agreement was entered into. (A54)

IV

Provident was at all pertinent times the beneficial owner of the securities.

The remainder of Provident's brief is directed to the proposition that it has no Section 16(b) liability with respect to the transaction at bar because it was acting in a fiduciary capacity. The very heading of this part of the argument—"The Transaction Was Exempt From §16(b) Because Provident Acted At All Pertinent Times On Behalf Of Its Shareholders"—gives the game away. If a corporation were exempt from Section 16(b) because it was acting "on behalf of its shareholders", corporate liability under that statute could be written off as a dead letter.

A. Provident Was Not a Liquidating Agent

Specifically with respect to the contention that Provident was acting as a liquidating agent (Res. Br. 52-57), we have discussed at length the requirements for this exemption in our opening brief. (Foremost Br. 55-59) Only two points raised by Provident need further response:

(1) Focusing on the language of subdivision (3) of Rule 16a-4, 17 C.F.R. §240.16a-4, without reference to paragraph (a), Provident contends that the Rule does not require court supervision of the fiduciary for its applicability. (Res. Br. 55) Paragraph (a) provides that "during the period of 12 months following their appointment and qualification, securities held by the following persons shall be exempt * * *." The important words are "appointment

and qualification." No court or other judicial or administrative body appointed or qualified Provident as a liquidating agent or other similar person. Provident was self-appointed and subject only to self-imposed qualifications if any; moreover, as discussed at length in our opening brief (Foremost Br. 55-58), until August, 1970 Provident was administering its own assets, not the assets of other persons.

(2) Provident would attach no importance to the use of the word "held" in the exempting Rule. It contends that it both bought and sold the securities as a liquidating agent, but nevertheless is exempt from Section 16(b). (Res. Br. 55) The word "held" implies that the Rule applies only to shares which devolved upon the fiduciary; this accords with "[t]he primary purpose of the rule * * * to permit liquidation without filing reports and without liability under §16(b) even though the insider (or late insider) happened to buy within less than six months before the fiduciary's sale." See 2 L. Loss, *Securities Regulation* 1111 (2d ed. 1961). Indeed, if the SEC promulgated a rule providing that a fully able and competent party such as Provident, having full control over its status, could attain 10% beneficial ownership and buy and sell securities within a six-month period with impunity, the rule would be subject to attack as beyond the SEC's exempting power which is limited to transactions "not comprehended within the purpose of [Section 16(b)]." See generally *Greene* v. *Dietz*, 247 F.2d 689 (2d Cir. 1957); *Perlman* v. *Timberlake*, 172 F. Supp. 246 (S.D.N.Y. 1959).

B. The October 13 Resolution Did Not Divest Provident of Beneficial Ownership

Provident continues to contend that its resolution of October 13, providing for the pro-rata distribution of the Foremost debentures as received upon dates to be established by Provident's officers, divested Provident of beneficial ownership once and for all. We have dealt with this argument (Foremost Br. 46-48), and here respond only to a few points not already discussed.

Provident suggests that the October 13 resolution was not "repudiated" as we contend. Yet it does not deny that $25,000,000 worth—more than half—of the debentures were not distributed in accordance with the resolution but were instead sold. Further, on December 9, 1969 Provident's directors enacted a resolution stating that it "ratified and approved" the "distribution to shareholders in cash and securities made to date." (A28) If the original resolution had been adhered to, such ratification would not have been necessary.

The considerations which led Provident to abandon its original plan of distributing the debentures and having its shareholders sell them were the fact that one shareholder could not be reached and others were minors. (Res. Br. 7) Yet if the right to the debentures as dividends had been vested in the shareholders on October 13 as Provident claims, such right would have been vested in all the shareholders, including Mr. Crocker in the Brazilian jungles and the minors. No majority vote of shareholders could divest the interest of those who did not vote. Yet Provident proceeded to sell, not distribute, the debentures. The conclu-

sion is inescapable from Provident's own contemporaneous action that the shareholders did not have a vested interest, and that the instant argument is simply an ineffectual attempt to avoid Section 16(b).

The legal authorities relied upon by Provident for its vesting argument are not in point. We have previously noted the distinction between dividends of on-going corporations (the cases relied upon) and liquidating distributions. (Foremost Br. 46-47) Immediate vesting cannot occur with respect to liquidating dividends because of the prior claims of creditors and preferred stockholders. Here there were the additional conditions precedent of receipt of the debentures and the fixing of a distribution date by the directors. In such a situation, the shareholders have only an expectancy, an expectancy which in this case was never fulfilled in the manner described in the resolution.

Meyers v. *El Tejon Oil & Refining Co.*, 29 Cal.2d 184, 174 P.2d 1 (1946), is not in point. It dealt with the question of whether defects in a non-liquidating dividend resolution by an on-going corporation could be cured by subsequent ratification and, if so, whether that ratification would have retroactive effect. The court held that "[e]ach holder of common stock acquired a vested right to the payment of the dividend, which cannot be defeated by later revocation of the dividend without his consent." 174 P.2d at 3.

Provident also refers to *Smith* v. *Taecker*, 133 Cal. App. 351, 24 P.2d 182 (1933), which also involved a non-liquidating dividend. It held that "[w]here the resolution declares a dividend as payable on a future date, title to said dividend vests in the stockholder on the date fixed in the resolution." 24 P.2d at 182. Provident's October 13 resolution did not

fix a payment date, and, as noted, dealt with what purported to be a liquidating dividend. Nothing in the *Smith* case supports Provident's characterization of it as holding that, even as to an on-going corporation, a dividend vests in a shareholder *as of the date of the resolution* (Res. Br. 59) in contrast to the date fixed by the resolution.

Conclusion

Provident became a 10% beneficial owner of Foremost equity securities by a voluntary purchase, voluntarily sold such securities within a six-month period, realizing a profit, and thus is liable under Section 16(b). In these circumstances, the judgment below must be reversed, and the case remanded with directions to the District Court to grant summary judgment to Foremost on the issue of liability and to set the case down for hearing as to the amount of damages.

Dated: New York, New York
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